Sample Tax Calculation
Comparing Effective Tax Rates for Three Income Levels
(Joint return, two exemptions, 1989 rates)

Taxable Income (Line 37 of Form 1040)	$50,000	$100,000	$180,000
Tax:			
15% bracket (0-$30,950)	$4,642.50	$4,642.50	$4,642.50
28% bracket (above $30,950)	$5,334.00	$19,334.00	$41,734.00
5% surtax bracket to eliminate benefit of 15% rate ($74,850 to $155,320)	0	$1,257.50	$4,023.50
5% surtax bracket to eliminate benefit of personal exemptions ($155,321 to $177,720)	0	0	$1,120.00
Tax liability	$9,976.50	$25,234.00	$51,520.00
Divided by total income subject to tax	$50,000.00	$100,000.00	$184,000.00
Effective tax rate	19.95%	25.23%	28%

An Historical Perspective on the Bubble

Why politicians agreed to such a complicated and seemingly unfair tax provision is perhaps easier to understand if put into an historical context. Contrary to contentions otherwise, the bubble is the result of a peculiar quirk in the tax code that was designed as part of the Tax Reform Act of 1986 to make the tax system more progressive.

In the final stages of negotiations on TRA, as agreement was reached to drop the top tax rate from 50 percent to 28 percent and to collapse the number of tax brackets, it was estimated that, unless amended, TRA as conceived would yield less in revenue than the existing tax system. In an effort to ensure revenue neutrality and inject greater progressiveness, a group of lawmakers proposed an additional 33-percent top rate on the highest income groups. The delicate coalition supporting the top rate of 28 percent threatened to come apart over the proposal for a third higher bracket.

To keep the coalition from dissolving, the Senate Finance Committee staff suggested that it would be possible to keep just two rates and still generate the needed revenue by taking away the benefit of the 15-percent initial rate on the first increments of income and all personal exemptions for taxpayers with taxable incomes above $170,000. As a result, higher-income taxpayers would pay the full 28-percent top rate on all their income. This proposal, while it would have kept just two rates, would have created an abrupt jump in tax liability as taxpayers reached the $170,000 threshold.

If this proposal had been adopted, the actual tax liability for individuals earning $170,000 would have been $5,144 more than the tax liability for individuals earning $169,999. Earning an extra dollar at this income level would have increased a taxpayer's tax liability by $5,144. The point where the average tax rate would have jumped abruptly to 28 percent is shown in Figure 5. The only way to avoid such a jump would be to phase out the benefits gradually, starting well before the $170,000 level. Congress eventually decided to apply a surcharge on higher-income taxpayers in order to phase out both the benefit of the 15-percent rate applied to the first increments of income and the benefit of personal exemptions. Such a surcharge is not unique in the tax code. Similar provisions phasing out benefits appear elsewhere in the tax code.

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Effect of Bubble ge Tax Rates
Using Income Subject .. as the Base
(1989 joint return, two exemptions)

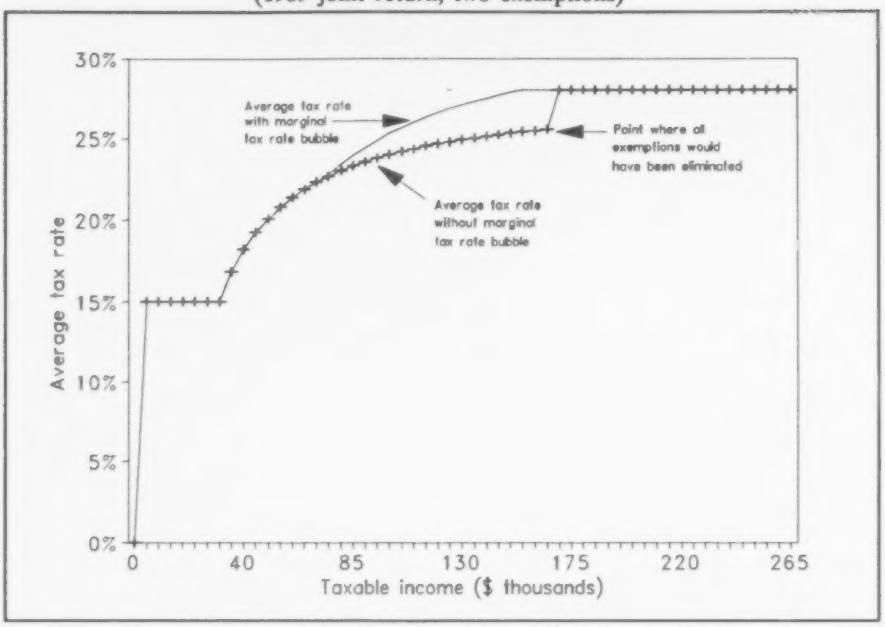


Figure 5 shows how the 5-percent surcharge which creates the bubble for upper middle-income taxpayers actually made TRA more progressive than originally proposed without causing a surge in the effective tax rate. Note that for incomes between $74,850 and $170,000, the average tax rate under current law lies above the average tax rate that would have applied had Congress adopted the Finance Committee staff plan with the $170,000 threshold. The graph shows that higher-income taxpayers face a higher tax liability as a percentage of their income than all other individuals.

The Effect of Bursting the Bubble

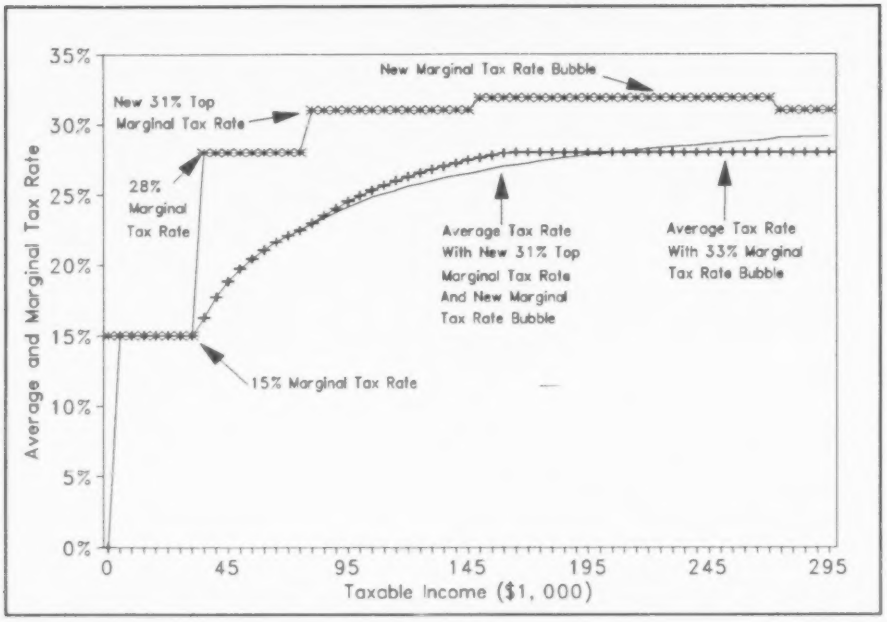
Recent budget negotiations focused on ways to raise revenue. High on many lawmakers' lists of possible tax increases was a proposal to burst the bubble by extending the 33-percent top tax rate to all taxable incomes above the current bubble. One common plan to burst the bubble would have eliminated the 5-percent surtax to phase out benefits and created, instead, an explicit top bracket of 33 percent for taxable income starting where the phaseouts begin currently, e.g., $74,850 for a joint filer claiming two exemptions.

After weeks of wrangling over the budget, Congress finally agreed to eliminate the current 33-percent marginal-tax-rate bubble and create a top marginal tax rate of 31 percent beginning where the bubble range starts currently. A new marginal-tax-rate bubble phasing out the benefit of personal exemptions would affect single taxpayers with taxable income between $100,000 and $225,000 and married couples with taxable income between $150,000 and $275,000. The new bubble will increase the marginal tax rate for affected taxpayers approximately 0.5 percent for each exemption claimed.

Figure 6 shows the new bubble for affected couples claiming only two exemptions. The new bubble will raise their marginal tax rate to nearly 32 percent. For couples with taxable income above $275,000 the marginal tax rate will drop back to 31 percent. As Figure 6 shows, however, the average tax rate, using income subject to tax as the base, never declines.

Comparison of the two average tax rate curves depicted in Figure 6 reveals that many taxpayers currently affected by the bubble will benefit from an average-tax-rate reduction because their marginal tax rate will drop from 33 percent to 31 percent. Other tax code changes such as limiting itemized deductions and increasing the maximum income limit for the medicare tax could

Figure 6
Average Tax Rates
Using Income Subject to Tax as the Base
Current Law versus 1990 Budget Act
(1990 joint return, two exemptions)



more than offset the benefit of the drop in marginal tax rates for individuals currently affected by the bubble.

Relationship to Other Proposals

In addition to modifying the bubble, Congress also decided to limit itemized deductions such as mortgage interest by allowing deductions only above a certain threshold. Allowable itemized deductions will be reduced by $300 for every $10,000 of taxable income in excess of $100,000, indexed for inflation, for both single and joint filers, not to exceed 80 percent of total itemized deductions. Under the new law, a taxpayer with a $150,000 income will not be able to deduct the first $1,500 of itemized deductions, resulting in a $495 tax increase assuming the taxpayer has itemized deductions of at least $1,500.

Distributional Impacts

Raising the top marginal tax rate to 31 percent will increase taxes for taxpayers with taxable income above approximately $200,000 for joint return filers and above roughly $100,000 for single return filers, the exact amounts depending on the number of exemptions claimed. Likewise, limiting itemized deductions as discussed above will increase taxes for all taxpayers filing itemized returns, single or married, with adjusted gross income above $100,000. As noted earlier, replacing the bubble with a 31-percent top marginal tax rate will reduce the average tax rate for taxpayers in the current bubble range. In contrast, the income tax liability for all other taxpayers with incomes below the current bubble range will remain unchanged by either the new limitation on itemized deductions or the new top marginal tax rate.

While limiting itemized deductions will reduce the value of such deductions to taxpayers with incomes above $100,000, increasing the top rate to 31 percent could, on net, increase the value of itemized deductions for many taxpayers above the bubble range, depending on the amount of itemized deductions claimed. A taxpayer with adjusted gross income of, say, $250,000 will not be allowed to claim the first $4,500 of itemized deductions since itemized deductions will be limited to deductions in excess of 3 percent of income above $100,000 which in this case amounts to 3 percent of $150,000 or $4,500. At a 31-percent marginal tax rate, the $4,500 limitation translates into a $1,395 loss in tax benefits (.31 x

$4,500). This $1,395 loss is completely recovered under the higher tax rate, however, if this taxpayer has itemized deductions of at least $46,500. For example, when itemized deductions reach $46,500, the tax benefit is $14,415 at a 31-percent marginal tax rate and only $13,020 at a 28-percent marginal tax rate resulting in a difference of $1,395, an amount which just offsets the tax loss from limiting itemized deductions.

Conclusion

To the casual observer at this point, the bubble probably seems like an overly complicated and trivial aspect of a mind-boggling tax system. Whether the bubble is the most efficient method to phase out the benefits of the 15-percent tax rate and personal exemptions is an issue beyond the scope of this paper. The facts concerning the bubble speak plainly, however: 1) The current bubble in the marginal tax rates does not cause any taxpayer to be subject to a higher average tax rate than another taxpayer with higher income subject to tax; 2) The new marginal-tax-rate bubble also will not cause any taxpayer to be subject to a higher average tax rate than another taxpayer with higher income subject to tax.

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[1] See Byrle M. Abbin, "The Bubble is No Anomaly," *Tax Notes*, October 2, 1989, p. 119.

[2] See Steve Charvonitz, "Yes, the Bubble Really Exists," *Tax Notes*, July 2, 1990, pp. 117-119.

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Existing Home Sales

Thousands of Units; Percent Change from One Month Ago; Percent Change from One Year Ago

	U.S.			Northeast			Midwest			South			West			
86.01	3,400	-1.2	13.3	730	5.8	28.1	910	-2.2	13.8	1,210	-1.6	9.0	540	-6.9	3.8	86.01
86.02	3,350	-1.5	13.6	680	-6.8	25.9	920	1.1	21.1	1,180	-2.5	4.4	560	3.7	5.7	86.02
86.03	3,270	-2.4	7.9	640	-5.9	12.3	950	3.3	20.3	1,110	-5.9	-2.6	570	1.8	5.6	86.03
86.04	3,580	9.5	18.2	710	10.9	24.6	1,070	12.6	33.8	1,220	9.9	7.0	590	3.5	11.3	86.04
86.05	3,440	-3.9	12.8	690	-2.8	21.1	980	-8.4	19.5	1,200	-1.6	8.1	580	-1.7	5.5	86.05
86.06	3,460	0.6	10.5	670	-2.9	9.8	990	1.0	16.5	1,220	1.7	8.9	580	0.0	5.5	86.06
86.07	3,510	1.4	9.7	680	1.5	7.9	950	-4.0	4.4	1,280	4.9	10.3	600	3.4	17.6	86.07
86.08	3,600	2.6	3.4	690	1.5	4.5	1,000	5.3	5.3	1,280	0.0	0.0	630	5.0	8.6	86.08
86.09	3,670	1.9	7.0	710	2.9	4.4	1,020	2.0	8.5	1,320	3.1	9.1	620	-1.6	3.3	86.09
86.10	3,670	0.0	7.0	720	1.4	4.3	1,000	-2.0	6.4	1,310	-0.8	7.4	650	4.8	10.2	86.10
86.11	3,860	5.2	13.5	710	-1.4	6.0	1,040	4.0	13.0	1,450	10.7	17.9	660	1.5	15.8	86.11
86.12	3,970	2.8	15.4	810	14.1	17.4	1,060	1.9	14.0	1,370	-5.5	11.4	730	10.6	25.9	86.12
87.01	3,580	-9.8	5.3	680	-16.0	-6.8	1,030	-2.8	13.2	1,270	-7.3	5.0	610	-16.4	13.0	87.01
87.02	3,730	4.2	11.3	720	5.9	5.9	1,080	4.9	17.4	1,310	3.1	11.0	620	1.6	10.7	87.02
87.03	3,770	1.1	15.3	740	2.8	15.6	1,120	3.7	17.9	1,320	0.8	18.9	590	-4.8	3.5	87.03
87.04	3,580	-5.0	0.0	680	-8.1	-4.2	1,020	-8.9	-4.7	1,280	-3.0	4.9	600	1.7	1.7	87.04
87.05	3,740	4.5	8.7	720	5.9	4.3	1,000	-2.0	2.0	1,390	8.6	15.8	630	5.0	8.6	87.05
87.06	3,520	-5.9	1.7	690	-4.2	3.0	910	-9.0	-8.1	1,280	-7.9	4.9	640	1.6	10.3	87.06
87.07	3,500	-0.6	-0.3	690	0.0	1.5	930	2.2	-2.1	1,260	-1.6	-1.6	620	-3.1	3.3	87.07
87.08	3,380	-3.4	-6.1	670	-2.9	-2.9	870	-6.5	-13.0	1,260	0.0	-1.6	580	-6.5	-7.9	87.08
87.09	3,400	0.6	-7.4	670	0.0	-5.6	900	3.4	-11.8	1,270	0.8	-3.8	560	-3.4	-9.7	87.09
87.10	3,430	0.9	-6.5	660	-1.5	-8.3	910	1.1	-9.0	1,280	0.8	-2.3	580	3.6	-10.8	87.10
87.11	3,330	-2.9	-13.7	660	0.0	-7.0	890	-2.2	-14.4	1,230	-3.9	-15.2	560	-3.4	-15.2	87.11
87.12	3,240	-2.7	-18.4	640	-3.0	-21.0	860	-3.4	-18.9	1,190	-3.3	-13.1	560	0.0	-23.3	87.12
88.01	3,200	-1.2	-10.6	610	-4.7	-10.3	920	7.0	-10.7	1,090	-8.4	-14.2	530	-5.4	-13.1	88.01
88.02	3,320	3.8	-11.0	660	8.2	-8.3	880	-4.3	-18.5	1,230	12.8	-6.1	540	1.9	-12.9	88.02
88.03	3,382	1.9	-10.3	650	-1.5	-12.2	870	-1.1	-22.3	1,270	3.3	-3.8	600	11.1	1.7	88.03
88.04	3,510	3.8	-2.0	660	1.5	-2.9	910	4.6	-10.8	1,320	3.9	3.1	620	3.3	3.3	88.04
88.05	3,620	3.1	-3.2	690	4.5	-4.2	910	0.0	-9.0	1,370	3.8	-1.4	640	3.2	1.6	88.05
88.06	3,800	5.0	8.0	720	4.3	4.3	1,000	9.9	9.9	1,410	2.9	10.2	680	6.3	6.3	88.06
88.07	3,650	-3.9	4.3	690	-4.2	0.0	930	-7.0	0.0	1,370	-2.8	8.7	660	-2.9	6.5	88.07
88.08	3,690	1.1	9.2	680	-1.4	1.5	930	0.0	6.9	1,400	2.2	11.1	670	1.5	15.5	88.08
88.09	3,650	-1.1	7.4	650	-4.4	-3.0	910	-2.2	1.1	1,390	-0.7	9.4	700	4.5	25.0	88.09
88.10	3,680	0.8	7.3	640	-1.5	-3.0	940	3.3	3.3	1,410	1.4	10.2	690	-1.4	19.0	88.10
88.11	3,710	0.8	11.4	680	6.3	3.0	940	0.0	5.6	1,410	0.0	14.6	680	-1.4	21.4	88.11
88.12	3,920	5.7	21.0	700	2.9	9.4	1,010	7.4	17.4	1,500	6.4	26.1	700	2.9	25.0	88.12
89.01	3,660	-6.6	14.4	680	-2.9	11.5	950	-5.9	3.3	1,360	-9.3	24.8	660	-5.7	24.5	89.01
89.02	3,550	-3.0	6.9	610	-10.3	-7.6	930	-2.1	5.7	1,350	-0.7	9.9	650	-1.5	20.4	89.02
89.03	3,430	-3.4	1.4	590	-3.3	-9.2	880	-5.4	1.1	1,300	-3.7	2.4	670	3.1	11.7	89.03
89.04	3,440	0.3	-2.0	610	3.4	-7.6	900	2.3	-1.1	1,300	0.0	-1.5	630	-6.0	1.6	89.04
89.05	3,250	-5.5	-10.2	600	-1.6	-13.0	840	-6.7	-7.7	1,220	-6.2	-10.9	590	-6.3	-7.8	89.05
89.06	3,330	2.5	-12.4	520	-13.3	-27.8	930	10.7	-7.0	1,280	4.9	-9.2	590	0.0	-13.2	89.06
89.07	3,380	1.5	-7.4	520	0.0	-24.6	940	1.1	1.1	1,310	2.3	-4.4	570	-3.4	-13.6	89.07
89.08	3,440	1.8	-6.8	570	9.6	-16.2	940	0.0	1.1	1,320	0.8	-5.7	570	0.0	-14.9	89.08
89.09	3,510	2.0	-3.8	600	5.3	-7.7	960	2.1	5.5	1,320	0.0	-5.0	620	8.8	-11.4	89.09
89.10	3,490	-0.6	-5.2	610	1.7	-4.7	970	1.0	3.2	1,300	-1.5	-7.8	610	-1.6	-11.6	89.10
89.11	3,560	2.0	-4.0	590	-3.3	-13.2	950	-2.1	1.1	1,390	6.9	-1.4	630	3.3	-7.4	89.11
89.12	3,560	0.0	-9.2	580	-1.7	-17.1	980	3.2	-3.0	1,390	0.0	-7.3	610	-3.2	-12.9	89.12
90.01	3,470	-2.5	-5.2	560	-3.4	-17.6	940	-4.1	-1.1	1,400	0.7	2.9	570	-6.6	-13.6	90.01
90.02	3,400	-2.0	-4.2	560	0.0	-8.2	890	-5.3	-4.3	1,310	-6.4	-3.0	650	14.0	0.0	90.02
90.03	3,400	0.0	-0.9	500	-10.7	-15.3	910	2.2	3.4	1,360	3.8	4.6	630	-3.1	-6.0	90.03
90.04	3,330	-2.1	-3.2	520	4.0	-14.8	920	1.1	2.2	1,300	-4.4	0.0	580	-7.9	-7.9	90.04
90.05	3,300	-0.9	1.5	520	0.0	-13.3	880	-4.3	4.8	1,320	1.5	8.2	570	-1.7	-3.4	90.05
90.06	3,330	0.9	0.0	490	-5.8	-5.8	960	9.1	3.2	1,310	-0.8	2.3	580	1.8	-1.7	90.06
90.07	3,330	0.0	-1.5	560	14.3	7.7	930	-3.1	-1.1	1,310	6.9	6.9	530	-10.3	-8.8	90.07
90.08	3,500	5.1	1.7	520	-7.1	-8.8	990	6.5	5.3	1,400	6.9	6.1	570	7.5	0.0	90.08
90.09	3,220	-8.0	-8.3	520	0.0	-13.3	920	-7.1	-4.2	1,260	-10.0	-4.5	520	-8.8	-16.1	90.09

Source: NATIONAL ASSOCIATION OF REALTORS

U.S. Economic Outlook: November 1990

Quarterly figures are seasonally adjusted annual rates

	90.2	90.3	90.4	91.1	91.2	91.3	91.4	92.1	1988	1989	1990	1991	1992
U.S. Economy													
Annual Growth Rate													
Real GNP	0.4	1.8	-0.9	-1.6	0.9	2.8	3.6	3.2	4.5	2.5	1.1	0.4	3.0
Industrial Production	4.1	3.7	1.9	-3.4	0.2	3.2	5.3	4.1	5.4	2.6	1.6	0.9	3.8
Civilian Employment	0.7	-1.5	-0.9	-0.4	-0.2	0.7	1.3	1.4	2.3	2.0	0.5	-0.3	1.3
GNP Inflation Index	4.7	4.6	5.6	5.8	4.0	3.3	3.4	3.7	3.3	4.1	4.4	4.8	3.4
Consumer Prices	3.7	7.9	6.0	6.8	4.8	4.0	4.0	3.8	4.1	4.8	5.5	5.7	4.0
Value of the U.S. Dollar	-2.0	-21.4	-13.9	-10.4	-6.1	-0.2	-0.3	0.7	-4.3	6.2	-9.4	-9.5	0.5
Percent													
Mfg. Capacity Utilization	82.7	82.8	83.1	81.9	81.4	81.4	81.7	81.8	83.9	83.9	82.8	81.6	82.0
Civilian Unemployment	5.3	5.5	5.9	6.2	6.4	6.4	6.3	6.2	5.5	5.3	5.5	6.3	6.0
Percent of GNP													
Federal Tax Receipts	20.3	20.2	20.3	20.5	20.4	20.3	20.3	20.5	20.0	20.2	20.2	20.4	20.5
Federal Expenditures	23.4	23.0	22.9	23.1	23.1	22.9	22.7	22.6	22.9	22.8	23.1	22.9	22.4
Federal Budget Deficit	-3.0	-2.8	-2.6	-2.7	-2.7	-2.6	-2.4	-2.1	-2.9	-2.6	-2.9	-2.6	-1.9
Interest Rates, Percent													
Federal Funds Rate	8.2	8.2	7.8	7.6	7.5	7.5	7.6	7.6	7.6	9.2	8.1	7.5	7.6
3-Month T-Bill Rate	7.7	7.5	7.3	7.1	7.0	7.1	7.1	7.2	6.7	8.1	7.6	7.1	7.1
Prime Rate	10.0	10.0	9.9	9.6	9.5	9.5	9.5	9.5	9.3	10.9	10.0	9.5	9.5
Discount Rate	7.0	7.0	7.0	6.9	6.8	6.8	6.8	6.8	6.2	6.9	7.0	6.8	6.8
Corporate AAA Bond Yield	9.4	9.4	9.4	9.2	9.1	9.0	9.0	8.9	9.7	9.3	9.3	9.1	8.8
30-Year Government Bond Yield	8.7	8.8	8.8	8.6	8.5	8.4	8.3	8.3	9.0	8.4	8.7	8.4	8.2
Mortgage Rates, Percent													
30-Year Fixed Rate	10.3	10.1	10.1	9.9	9.7	9.6	9.6	9.5	10.3	10.3	10.2	9.7	9.4
1-Year Adjustable	8.6	8.4	8.4	8.3	8.3	8.2	8.2	8.1	8.5	9.3	8.4	8.3	8.1
Home Sales & Starts													
Thousands													
Total Single-Family Sales	4,188	4,188	4,023	4,044	4,082	4,138	4,173	4,208	4,648	4,446	4,218	4,109	4,252
(Single-family resales plus 97% of single-family starts)													
Existing Single-Family Sales	3,320	3,350	3,211	3,203	3,228	3,240	3,248	3,289	3,594	3,467	3,326	3,230	3,330
New Single-Family Sales	540	528	516	509	515	521	533	544	676	654	544	520	539
Housing Starts	1,204	1,143	1,095	1,145	1,161	1,220	1,271	1,277	1,491	1,386	1,224	1,199	1,298
Single-Family Units	895	864	838	867	881	926	954	947	1,086	1,010	920	907	950
Multi-Family Units	309	279	257	279	280	293	317	330	405	377	304	292	349
2-4 Family Units	44	38	35	38	38	40	43	45	59	55	40	40	48
5+ Family Units	265	241	222	241	242	253	274	285	347	321	264	252	301
Mobile Homes Shipped	190	186	179	186	187	192	198	197	218	199	188	191	197
Percent change – Year Ago													
Total Single-Family Sales	-2.7	-5.0	-10.5	-9.6	-2.5	-1.2	3.7	4.1	0.4	-4.3	-5.1	-2.6	3.5
Existing Single-Family Sales	-0.6	-2.7	-9.2	-6.4	-2.8	-3.3	1.2	2.7	2.4	-3.6	-4.1	-2.9	3.1
New Single-Family Sales	-15.1	-24.5	-20.9	-14.0	-4.6	-1.3	3.3	6.8	0.8	-3.3	-16.8	-4.5	3.8
Housing Starts	-1.1	-14.5	-18.7	-21.2	-3.5	6.7	16.0	11.5	-8.6	-7.0	-11.7	-2.0	8.2
Single-Family Units	-1.0	-13.2	-15.2	-20.0	-1.5	7.2	13.8	9.3	-5.9	-7.0	-8.9	-1.4	4.7
Multi-Family Units	-1.5	-18.5	-28.5	-25.0	-9.3	5.0	23.3	18.5	-14.9	-7.1	-19.2	-3.9	19.3
2-4 Family Units	-1.8	-31.8	-34.0	-12.0	-12.2	5.0	23.3	18.5	-10.0	-5.7	-27.7	-0.3	19.3
5+ Family Units	-1.4	-15.9	-27.5	-26.7	-8.9	5.0	23.3	18.5	-15.7	-7.3	-17.8	-4.5	19.3
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.2	96.6	96.9	97.2	97.3	98.1	98.8	99.3	89.2	92.9	96.4	97.9	100.4
New Home Prices	126.7	117.8	115.4	116.8	118.1	122.1	124.9	125.8	113.4	120.4	120.8	120.5	124.0
Percent Change - Year Ago													
Existing Home Prices	3.5	1.7	4.6	1.3	1.1	1.6	2.0	2.2	5.0	4.2	3.7	1.5	2.6
New Home Prices	6.0	-1.6	-7.2	-5.2	-6.8	3.7	8.2	7.7	8.3	6.2	0.3	-0.2	2.9

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo and Robert Barr.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

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REAL ESTATE OUTLOOK

Vol. 3, No. 12 December 1990

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Preliminary data suggest that growth in the fourth quarter of 1990 will be negative, and it's widely believed that the following quarter will also show economic contraction. If so, then the usual definition of a recession would be satisfied: Two quarters of negative growth.
- The recession, according to NAR's projections, will be relatively mild, with a decline only about one-third as deep as the average decline in the eight previous post-World War II recessions. A recovery is expected to take root by mid-year, making the two halves of the year dramatically different in terms of economic performance. Measured on a year-over-year basis, economic growth in 1991 will drop to a minuscule 0.1 percent but rebound to 2.8 percent in 1992.
- Housing starts dropped to an annual rate of 1,041,000 during October, marking the ninth consecutive month of decline. The pace is the lowest rate since the end of the last recession in October 1982. Relative to the first ten months of 1989, the pace of housing starts so far this year is down almost 12 percent. Single-family starts are down 8 percent; multi-family starts are down almost 21 percent.
- The new home sales rate dipped below the half-million mark in October, when the annual pace fell 3.5 percent to 491,000 units. Sales of new homes are expected to average 487,000 in the final quarter of 1990, down 7.6 percent from the third quarter. It is possible that the buying opportunities afforded by lower mortgage rates and rising incomes in late 1991 and into 1992 may catch home builders short of supply.
- The deteriorating economy caused existing home sales to decline 4.7 percent to their lowest level in nearly six years. In the two months since posting a sizable gain in August, sales dropped by a cumulative 13.7 percent to stand at an annual rate of 3,020,000 units. The rebound in the economy and lower interest rates will push existing home sales up in the last half of 1991. Sales are projected to be down 3.0 percent in 1991 but up 7.2 percent in 1992.

IN THIS ISSUE

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The Circle Game

by
John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

A President, recently rebuffed at the polls, struggles to deal with a Mideastern madman holding Americans prisoner; the economy, shocked by rising oil prices, a weakened housing sector and growing inflation, slides toward recession. George Bush and 1990? Wrong. Try Jimmy Carter and 1980. As my more adventuresome graduate school chums used to murmur through the haze, "What goes around comes around." And shocking as it may be, what's going on now in the economy is not only not new, it's not even as interesting.

Economists like to characterize *homo economicus* as the ultimate rational individual, deciding on expenditures and work effort only on the basis of prices and utility; in reality "economic man" is myopic, choosing to believe that what happened yesterday will happen forever -- until things change, and then *that* will happen forever. So we look at our situation, bemoan the fact that the great party that was the Eighties is over, and prepare to plunge into the end of civilization as we know it.

Well, all that may be fine for those who reached economic maturity in the past decade and thus have no real basis for comparison, but in reality the mess that opened the Eighties was far worse than anything we are likely to experience in the next year (Omigosh, he's starting another "Now, listen sonny, in my day..." lecture!).

At that time, the contraction rate of GNP had reached 6 percent, interest rates were forty percent higher than where they are now, and inflation was moving rapidly into double digits. Gasoline prices, that oft-used barometer of consumer well-being, were (in today's dollars) a little over $2 a gallon. I think we would be utterly shocked if anyone with the least pretension to respectability would suggest that these figures will be repeated in 1991.

But, in the world of economic life, everything is relative. After all, the Nixon Administration imposed a wage and price freeze on the economy in August 1971 because inflation had "skyrocketed" to *four* percent. Today, we would find nothing remarkable about that rate.

When we can recall growth of over three percent in the recent past, the third quarter number of 1.7 percent looks grim; unemployment of 6 percent is painful when 5 was the norm, and selling 3.3 million existing homes rather than 3.7 million is accounted as a bad year. This economic performance is nothing to write home about, but compare it to the recession of 1981-82, when the corresponding figures at the bottom were -2.5 percent for GNP, 9.7 percent for unemployment, and 2.0 million homes.

At that time we were facing a generally hostile OPEC, who was withholding oil production as a gambit to turn the West against Israel. Now the situation is very different. We have sent nearly a quarter million troops to Saudi Arabia to protect most of the Arab oil producers against Iraq. In gratitude, they are pumping oil at record rates. Barring a protracted shooting war, we can expect that oil prices will fall in the near future, a development that ought to bolster consumer confidence and offset recessionary momentum.

Another thing that's very different now is the role of the Federal Reserve in the economy. In 1980, the Fed had just shifted to a new way of targeting monetary policy that emphasized interest rates and growth rather than monetary aggregates. At the time, this looked like madness since rates were skyrocketing as fast as the economy was plunging. But this had to occur before the new policies would work, and it did and they did. The moderate inflation rates of the past seven years and the relatively mild fluctuations in interest rates are testimony to the wisdom of this change.

So in this slump of 1990, we have a monetary policy that is more sure of itself and therefore more able to use interest rates to bring back growth. We have seen recently the Fed move to lower interest rates and will likely see similar moves in the coming months. That will shorten this slowdown and lessen its severity.

The other major difference between 1980 and 1990 is the degree to which the world economy is interrelated. To most Americans, that means the Japanese buying Rockefeller Center or Universal Studios (No, folks, King Kong will not be replaced by Godzilla in Hollywood and Orlando). But it also means that recession will have little impact on the Midwest, because we sell more goods abroad, or on Florida, because we attract more and more foreign tourists.

The most interesting thing about the integration of the economies of the world is that the price system works. If the dollar falls in value, American goods are less expensive to foreigners; if there are no barriers to trading, that translates into effective demand. And so it is. The dollar has been falling in value in recent months, to levels hitherto unknown in many currencies. The result will be a continued growth in export production and thus a major offset to economic slowdown. In 1980, there was no similar mechanism to help out when other economic systems began to shut down.

The point here is not that the world is rosy. Even if we avoid technical recession (two consecutive quarters of contraction in real GNP), the weak growth that this economy has experienced in recent years ought not to be tolerated. But if history is any guide, we may well be viewing the prelude to yet another sustained spurt of economic growth.

Contrary to popular wisdom, history does not repeat itself. Rather, history is like a spiral: when it comes full circle, it's with a slightly different context. Some things are similar, but enough is different to require a real hard look. And that's what we need to do. It is best summed up by Joni Mitchell:

> *We're captive on a carousel of time.*
> *We can't return, we can only look*
> *Behind from where we came,*
> *And go round and round and round*
> *In the circle game.*

Outlook for the Economy and Real Estate

Last month was to have been the eighth anniversary of the longest peacetime expansion in U.S. history, but recent data has made any celebration moot. It's almost a sure bet that growth in the fourth quarter of 1990 will turn out to be negative, and it's widely believed that the following quarter will also show economic contraction. If so, then the usual definition of a recession would be satisfied: Two quarters of negative growth.

The recession, according to NAR's projections, will be relatively mild, with a decline only about one-third as deep as the average decline in the eight previous post-World War II recessions. A recovery is expected to take root by mid-year, making the two halves of the year dramatically different in terms of economic performance. The economy is projected to contract at a 1.0 percent rate during the first half but then expand at a 2.9 percent rate in the second half. Measured on a year-over-year basis, economic growth in 1991 will drop to a minuscule 0.1 percent but rebound to 2.8 percent in 1992.

Roots of the Recession

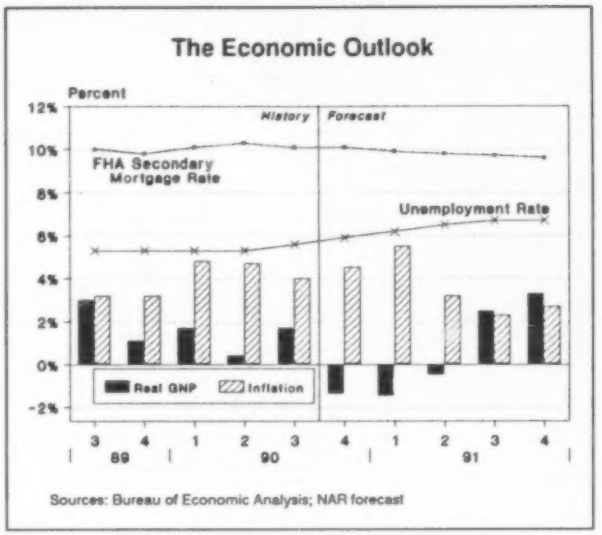
The major cause of the recession has been the Federal Reserve's tight monetary policies of the late 1980's. Designed to fight inflation by slowing economic growth, the Fed's "soft landing" approach raised short-term interest rates significantly in 1988. This led to the slowdown in growth that became evident in 1989 and brought the economy to the brink of recession by the late summer of 1990. Other forces have contributed as well, and chief among those was the credit crunch that evolved in response to the S&L crisis.

Then, in late July 1990, OPEC agreed to increase the price of oil by about 25 percent to $21 per barrel. Oil prices on the spot market moved upward after the announcement and surged days later when Iraq invaded Kuwait. The subsequent embargo of Iraqi and Kuwaiti oil and the threat of war kept oil prices high -- and, probably, pushed the U.S. economy into a recession. And as consumers read newspaper stories about the Gulf, they also saw that the government was ready to raise their taxes.

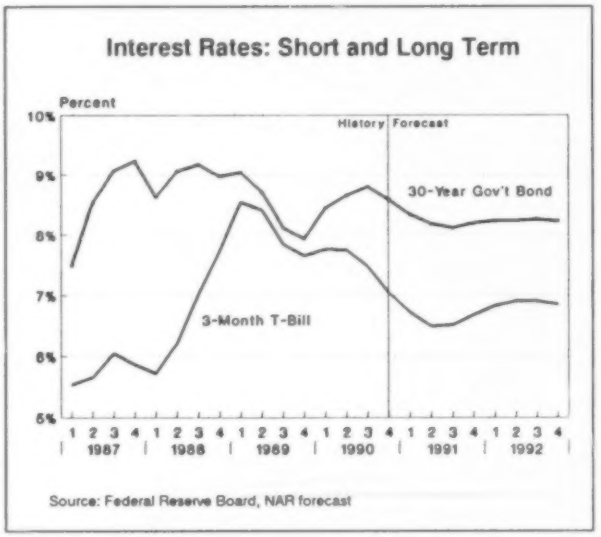
The Slowdown Becomes A Recession

Higher oil prices, higher taxes, and fears of war translated into a sharp drop-off in consumer confidence. October's plunge in the Conference Board's index was followed by further deterioration in November. This is being reflected at the cash registers, as retailers are reporting a slow holiday season so far. With disposable income and the savings rate falling, consumers are less willing to make big-ticket purchases: The annual sales rate of domestically-produced autos fell to 5.3 million units in late November, down from the year-to-date average of 6.9 million units.

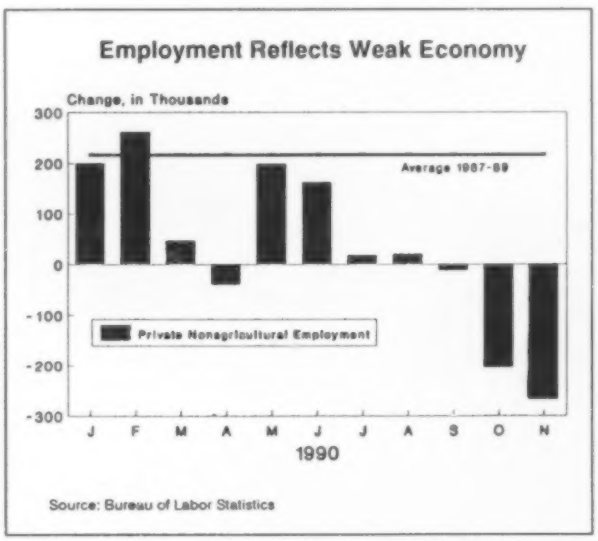
November's employment report, released in early December, shows the clearest sign that the soft landing has evolved into a recession. The graph at right shows that private nonfarm payrolls have been cut by almost half a million jobs in the past two months and that in only one month in 1990 did job growth exceed the average monthly gain during 1987-89. Construction payrolls fell for the sixth consecutive month, shedding 253,000 jobs -- with a quarter



Sources: Bureau of Economic Analysis; NAR forecast



Source: Federal Reserve Board, NAR forecast



Source: Bureau of Labor Statistics

of the losses coming in November alone. Manufacturing jobs, meanwhile, fell by another 200,000.

The Fed Eases

The Federal Reserve showed its concern over the economy's direction by cutting its target interest rate in the federal funds market to 7.25 percent from 7.5 precent in reaction to November's employment data. That makes for a three-quarter point cut since the end of October and suggests that the Fed has shifted some of its focus away from fighting inflation. In another counter to the credit crunch, the Fed lowered banks' reserve requirements, a move which allows banks to use more of their depositors' funds for making loans.

While the Fed appears more concerned about the recession than inflation, neither of these moves has sparked new fears of spiraling inflation. Inflation is expected to peak at 7.9 percent in the fourth quarter of 1990, as the economy continues to adjust to the fall's higher oil prices. During 1991, two factors will pull inflation down: the slack in the economy and the projected drop in oil prices.

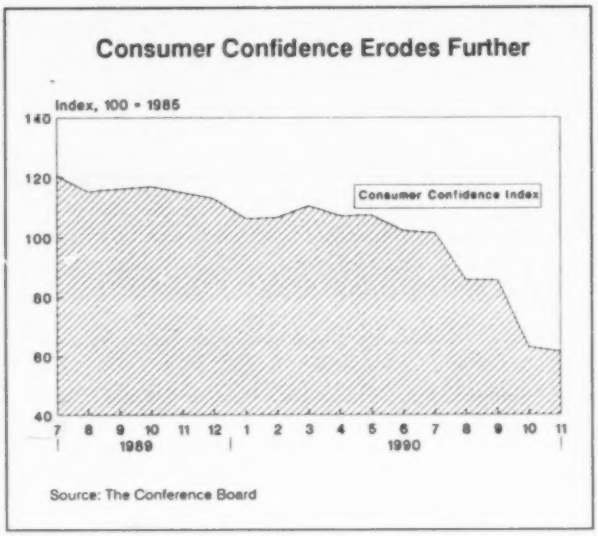
In addition to inflation and recession, the Fed is also concerned with the weakness in the dollar. It's fallen about 16 percent in the past year, with almost half of the decline coming in the past four months. While this helps exports by making U.S. goods relatively less expensive, it also raises concerns among international investors about purchasing dollar-denominated assets, such as Treasury bonds, which fall in value as the dollar falls. To compensate themselves against this risk, investors may require higher returns -- keeping U.S. interest rates higher than they would be otherwise.

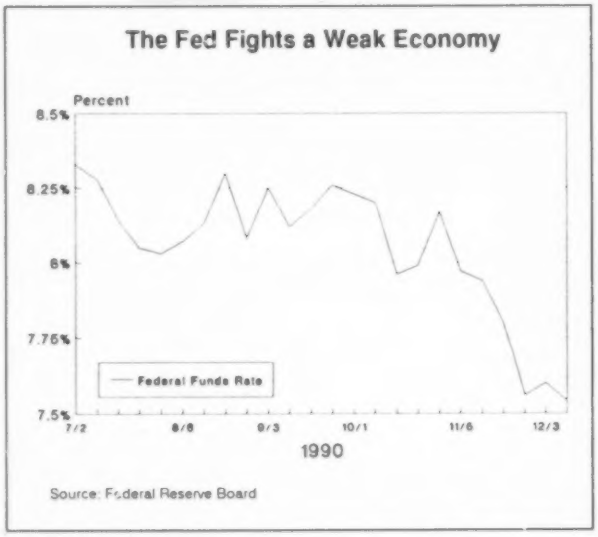
A Mild Recession in Sight

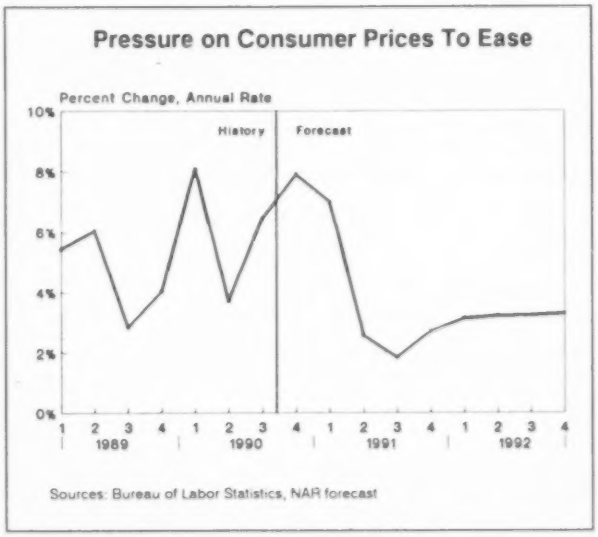
While most indicators are signalling recession, some are suggesting that the downturn will be mild. First, interest rates are falling. While the effect of the Fed's current easing may not be felt for months, at least interest rates were already headed in the right direction. In the five months prior to the start of the deep 1981-82 recession, short-term rates *rose* 1.6 percentage points, but in the five months before October 1990, short-term rates *fell* 0.4 percentage points.

Inventories are also lean, according to inventories-to-sales ratios. Since a drop in demand usually preceeds a cut in production, inventories usually rise abprutly before entering a recession. Businesses in turn order dramatic cuts in production to bring inventories down. But in this recession, the production cutbacks are expected to be relatively modest since the increase in inventories over the past two quarters was only $17 billion (in 1982 dollars). By comparison, in the two quarters prior to the 1981-82 recession, inventories rose by almost $50 billion.

Finally, a diplomatic solution to the Persian Gulf crisis would remove the embargo and place severe downward pressure on the price of oil. This reversal in the oil shock would lead to improvement in inflation and an increase in household real income, contributing to economic growth by mid-1991. The forecast assumes a peaceful resolution and a subsequent decline in oil prices.







Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

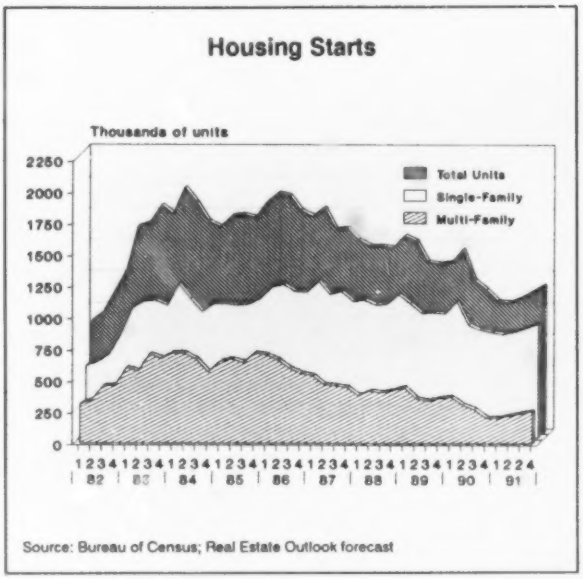
National Data

	Total	SF	2-4	5+
Oct 1989	1,423	1,023	60	340
Jun 1990	1,189	889	42	258
Jul 1990	1,153	875	29	249
Aug 1990	1,131	836	30	265
Sep 1990	1,107	863	34	210
Oct 1990	***1,041***	***854***	***31***	***156***
Annual Averages:				
1988	1,491	1,086	59	347
1989	1,386	1,010	55	321
Percent Changes in October 1990 since:				
Oct 1989	-26.8	-16.5	-48.3	-54.1
Sep 1990	-6.0	-1.0	-8.8	-25.7

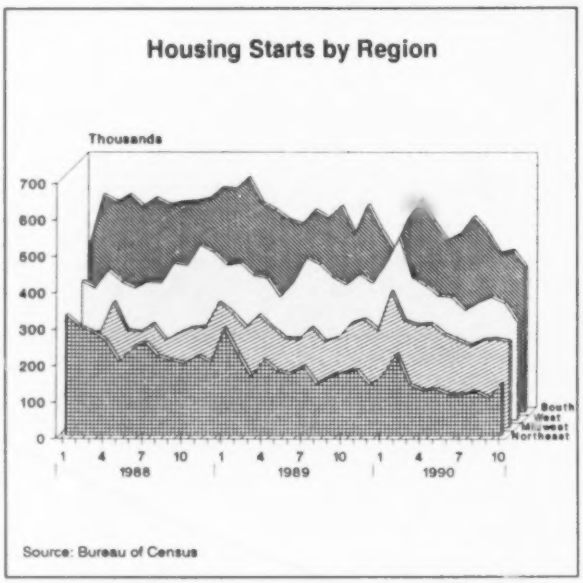
Regional Data

	Northeast	Midwest	South	West
Oct 1989	174	285	567	397
Jun 1990	113	241	535	300
Jul 1990	113	225	493	322
Aug 1990	120	241	434	336
Sep 1990	104	242	441	320
Oct 1990	***144***	***236***	***395***	***266***
Annual Averages:				
1988	240	273	574	404
1989	183	270	536	397
Percent Changes in October 1990 since:				
Oct 1989	-17.2	-17.2	-30.3	-33.0
Sep 1990	38.5	-2.5	-10.4	-16.9

Source: Bureau of Census, Construction Reports, Series C25



Source: Bureau of Census; Real Estate Outlook forecast



Source: Bureau of Census

Housings starts dropped to an annual rate of 1,041,000 during October, marking the ninth consecutive month of decline. The pace is the lowest rate since the end of the last recession in October 1982. Relative to the first ten months of 1989, the pace of housing starts so far this year is down almost 12 percent. Single-family starts are down 8 percent; multi-family starts are down almost 21 percent.

Housing starts in the Northeast jumped in October to an annual rate of 144,000 units, up almost 40 percent from September's rate. In light of the weakening economy, it is doubtful that the region will be able to maintain this pace over the next six months. The other three regions experienced delcines in October.

Year-to-date figures show the divergent regional performances in housing starts. Relative to the same period in 1989, the pace of starts in the first ten months of 1990 dropped 27 percent in the Northeast, 12 percent in the West, and 11 percent in the South. The starts rate in the Midwest has held even with last year's pace.

Housing starts are not expected to reach bottom until the first quarter of 1991, when they are projected to average 1,043,000 units. A recovering economy and lower mortgage rates will spur home building in the second half of 1991. While starts are expected to post a 12 percent increase in 1992 -- numbering 1,220,000 units -- they will remain only four-fifths of 1988's activity.